Issues and Problems Related to Eurozone Entry of the New Accession Countries: An Analytical Review

Miroslav Beblavý

Introduction

This chapter focuses on issues related to the entry to the eurozone of eight new EU member states from Central and Eastern Europe (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia). It does not deal with the two new member states that have not undergone the transition from a centrally planned economy to a market-based one (Cyprus and Malta).

As part of their accession process, all eight former communist countries of Central and Eastern Europe agreed to adopt the single currency and join the eurozone after their accession. There is no transitional period, permanent derogation or waiver, but an official expectation that they will join once they have achieved 'a sufficient degree of sustainable nominal convergence... examined by means of the Maastricht convergence criteria' (Issing, 2005, p. 1). This is embodied in Article 4 of the Treaty of Accession, whereby all new member states received the status of 'Member States with derogation' regarding EMU membership (European Commission, 2004, p. 2).

Even though these countries share, in addition to this commitment, many macroeconomic and structural similarities, the expected dates for their entry into the eurozone vary from 2007 to the yet unknown. The differences are not related to popular attitudes towards the EU or the euro, but to the underlying structural strengths and weaknesses of the respective economies as well as the domestic political will to deal with the problems.

Since eventual EMU accession is a *fait accompli* in the new member states, this chapter does not concern itself with optimum currency theories or other ways of determining whether monetary integration is a suitable recipe for the eight new member states. Rather, it will look into factors underlying the differences between their environments and the consequences for monetary policy in the run-up to EMU. After briefly examining monetary policy frameworks and exchange rate strategies during the transi-

tion, and looking at drivers of popular opinion on the euro, we turn to an analysis of the five Maastricht criteria.

The core of the chapter then examines which of the Maastricht criteria has been a binding constraint for the economic policy of each country and how policy-makers have been dealing with these constraints and their influence on the expected entry date. While the debt or interest rate criteria have not generally been a major problem and the exchange rate stability criterion is treated as an afterthought, the fiscal deficit and inflation criteria will be documented as the real challenges.

Background to monetary and exchange-rate developments since the late 1990s

Even though all the countries in question are former postcommunist countries that embarked on the transition to a market economy at the same time in the 1989–91 period, their initial macroeconomic and microeconomic conditions differed substantially. Nonetheless, despite widely varying initial conditions, all the countries have been able to implement rapid reforms and achieve successful structural adjustment. After the initial depression in the early 1990s that was associated with the beginning of transition, the break-up of the Soviet Union and the introduction of economic liberalisation, they have enjoyed relatively strong growth performance with the exception of one further slowdown, which occurred for each country at a different time, but was associated with the Russian and Asian crises as well as with the accumulated micro- and macroeconomic debris of reform. As we can see from Table 11.1, the second pause did not involve a sustained period of decline in output (with the exception of the Czech Republic). These countries therefore entered the EU in May 2004 with both an experience and an expectation of growth.

Table 11.1 Real GDP growth, eurozone and new member states (%)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Eurozone	2.7	3.0	3.0	3.9	1.9	1.2	1.2	2.4	1.6
Czech Republic	-0.7	-1.1	1.2	3.9	2.6	1.5	3.2	4.7	6.0
Estonia	11.1	4.4	0.3	7.9	6.5	7.2	6.7	7.8	9.8
Latvia	8.3	4.7	4.7	6.9	8.0	6.5	7.2	8.5	10.2
Lithuania	7.0	7.3	-1.7	3.9	6.4	6.8	10.5	7.0	7.5
Hungary	4.6	4.9	4.2	6.0	4.3	3.8	3.4	4.6	4.1
Poland	7.1	5.0	4.5	4.2	1.1	1.4	3.8	5.3	3.2
Slovenia	4.8	3.9	5.4	4.1	2.7	3.5	2.7	4.2	3.9
Slovakia	4.6	4.2	1.5	2.0	3.8	4.6	4.5	5.5	6.0

Source: Eurostat.

On their transition path, the eight countries shared several features of their economic and political environments that shaped their monetary policy choices. A brief summary follows (for more detail, see Beblavý, 2006).

All the countries had a high and increasing level of economic openness. While in the case of trade the transition period built on trade flows inherited from the communist period, financial flows started from a very limiting regulatory environment and correspondingly low base but increased rapidly. In terms of the regulatory environment, the countries studied covered the same path to financial liberalisation in 12 years that the developed countries took 50 postwar years to achieve.

In terms of inflation developments, the countries experienced an uncommonly large role played by those factors influencing price developments that were unrelated to monetary or fiscal policies as such. Both regulated prices and supply-determined prices, such as those of food and commodities, have had a much higher share of the consumer basket than in developed economies, making much of the development of prices directly unresponsive to monetary policy. Additionally, the transition countries started transition with a combination of structural deficiencies in the economy and price regulation which led to imbalances in relative prices and to prices that did not clear the market. The results were a low price level and a burst of inflation upon price liberalisation that continued to reverberate for much of the transition. Shifts in relative prices accompanying the adjustment process created an upward and persistent pressure on inflation in transition countries above and beyond their direct influence.

Consequently, initial conditions, inflationary pressures unrelated to monetary and fiscal policies and fiscal looseness in some countries led to a high initial and often continuing level of inflation. Due to high levels of financial openness and other factors, monetary policy in these countries faced a paradox not unusual in small, open economies – while the overall objective was related to disinflation, the actual policy was driven primarily by considerations of external (im)balance. The reason is that imbalances between aggregate supply and aggregate demand tended to lead to the deterioration of the current account, while the inflationary impact was felt only later when measures taken to address the current account problems increased inflation. In economies with a longer history of such problems (in particular Hungary, to some extent Poland), awareness of the issue caused a spillover of external imbalances directly into heightened inflation expectations. Additionally, the working of the interest-rate channel of monetary policy was often scrambled due to dysfunctionalities in the financial sector and peculiarities in its relationship with the real economy, so the exchange rate was the strongest and the most immediate channel of transmission.

The reaction of policy-makers and their various monetary policy frameworks and exchange-rate strategies are contained in the following six brief

sketches that encompass all eight countries. A summary is provided in Table 11.2.

Estonia and Lithuania established currency boards shortly after their independence and the hard peg has remained their exchange rate regime as well as monetary policy framework ever since, with a shift from the dollar to the euro as the anchor currency in Lithuania. This approach was justified by the low credibility of their monetary policy and their essentially non-existent currency reserves after the break-up of the Soviet Union. At the same time, both countries introduced unlimited convertibility of their currencies and free movement of capital.

Their policy framework remained unaffected by ERM II entry as currency boards are seen as an acceptable modification of the ERM II framework provided the euro is the sole reserve currency and multilateral obligations of other members of ERM II are not different from what they would be under normal circumstances. Both countries entered ERM II at the earliest opportunity (less than two months after the EU accession) and planned on the earliest possible date for the adoption of the euro – 1 January 2007 – though Estonia had to give this up recently because it did not fulfil the inflation criterion.

Their Baltic neighbour, Latvia, has practiced a little less rigour and, since 1994, has had in place an intermediate exchange rate regime – a peg to the SDR with a very narrow band of 1 per cent. In practice, the difference in monetary policy has been minuscule as this narrow peg was accompanied by a complete liberalisation of the capital account. ERM II entry in May 2005 meant only a shift of the anchor currency to the euro and the expected date for the adoption of the euro is 1 January 2008.

The Czech Republic and Slovakia had a soft peg tied mainly to the deutschmark and the dollar until 1997, a heritage of their joint Czechoslovak policy started in 1991. After several years with just one devaluation in Slovakia (in 1993) and none in the Czech Republic, both abandoned their soft pegs under the pressure of currency crises, in 1997 and 1998 respectively. Since then, they have pursued inflation-targeting coupled with managed floats. In the Czech case, this framework had an explicit form of direct inflation-targeting, whereas in the Slovak case the inflation-targeting was implicit in the way the central bank set and announced its targets, but there was no medium-term framework and no clear commitment to a medium-term inflation target until 2005. In November 2005, Slovakia entered ERM II with the target date of euro adoption on 1 January 2009. In the Czech Republic, there is not yet an official target date though the government has announced that it sees 1 January 2010 as the likely date.

Slovenia pursued a policy of a heavily managed float after its independence in 1991. The exchange rate also served as the intermediate target of monetary policy, with the central bank applying a policy of gradual and

Table 11.2 Summary of monetary policy frameworks in new member states

	Monetary policy framework in place from early 1990s until ERM II entry	ERM II entry date	Monetary policy framework in place after ERM II entry	Official expected euro adoption date
Czech Republic	Exchange rate target: peg to basket of dollar and deutschmark (until 1997); direct inflation target and managed float (since 1998)	-	-	1 January 2010
Estonia	Exchange rate target: currency board to deutschmark between 1992 and 1999, to euro since 1999	28/6/2004	Unchanged	1 January 2007
Latvia	Exchange rate target: peg to SDR (since 1994)	2/5/2005	Exchange rate target: peg to euro with 1% band	1 January 2008
Lithuania	Exchange rate target: currency board to dollar between 1994 and 2002, to euro since 2002	28/6/2004	Unchanged	1 January 2007
Hungary	Exchange rate target: crawling peg to basket of currencies gradually moving towards euro (until 2001); direct inflation target and ERM II-like peg to euro since 2001	-	-	1 January 2010
Poland	Exchange rate target: crawling peg with gradually widening band from 1991 until 2000 to basket of currencies gradually moving towards euro; direct inflation target and managed float (since 2000)	-	-	-
Slovenia	Exchange rate target: heavily managed float	28/6/2004	Exchange rate target: ERM II	1 January 2007
Slovakia	Exchange rate target: peg to basket of dollar and deutschmark (until 1998); managed float and implicit inflation targeting (between 1999 and 2005); switch to explicit inflation targeting prior to ERM II entry in 2005	25/11/2005	Exchange rate target: ERM II and inflation target	1 January 2009

Source: European Commission, central bank websites.

continuous depreciation. Since both a floating currency and a continuous depreciation are incompatible with ERM II, Slovenia changed its exchange rate policy with ERM II entry in June 2004 and stabilised the exchange-rate close to the new parity, where it has remained ever since. Slovenia plans to switch to the euro on 1 January 2007 and is likely to fulfil all the criteria.

Hungarian monetary policy has some echoes of the Slovenian approach though via different means. After a policy of discretionary and frequent devaluation between 1991 and 1994, Hungarian policy-makers switched to a crawling peg mechanism in 1994. The rate of crawl was gradually decreased until, in 2001, the crawling peg was transformed into a fixed peg. In preparation for eventual ERM II entry, a new 15 per cent band was also adopted at the same time. Since then, Hungary has followed a shadow ERM II regime, though it has adjusted the parity several times. The official Hungarian target for euro adoption is 1 January 2010.

Poland also adopted a crawling peg in the early 1990s, but later chose a different exit strategy from Hungary. Combining a decrease in the rate of crawl and an extension of the permissible trading band around the parity, it gradually moved towards a lightly managed floating currency, completing the shift in 2000. In 1998, it also introduced direct inflation targeting. Poland is the only country not to have an expected date for entry into the eurozone.

Overall, the countries analysed here have been able, despite the heritage of the command economy and other challenges, to achieve macroeconomic stability and, by the early 2000s at the latest, to successfully reduce inflation to single-digit levels. Even though they have not always avoided currency crises, these have not had a significant impact on their long-term growth prospects. The challenge of the Maastricht inflation criterion, however, is proving to be trickier for some as will be shown below.

Popular attitudes towards the euro

To understand the political economy of euro adoption in the new member states, it is useful to understand popular views on the subject. As we can see from Table 11.3, popular enthusiasm for the introduction of the euro is quite subdued in the new member states and the level of support is dropping. The citizens of the three Baltic states are most sceptical with approval rates in the 21–25 per cent range. At the other end of the spectrum, Hungary and Slovenia are now the only new member states where supporters outweigh opponents. The Czech Republic and Poland are between the two extremes. Slovakia is an interesting case which would have been firmly in the pro-euro camp a year ago, but has now moved to the other side.

There is a universally accepted worry about the abuse of the changeover by merchants to increase prices, though the numbers for Hungary and Slovenia are again notably lower. There is a clear statistical link between

Table 11.3 Views on euro adoption in new member states, September 2005

	Are you personally happy about euro replacing national currency?			Are you afraid of abuse of prices during the changeover?		What will be the likely effect of the euro on prices?	
	happy	change since September 2004	unhappy	change since September 2004	yes	contribute to price stability	increase inflation
Czech Republic	33	-6	58	+3	66	18	43
Estonia	24	-5	64	+7	66	17	61
Latvia	21	-2	64	+5	69	15	61
Lithuania	25	-9	69	+11	78	14	71
Hungary	49	-7	37	+4	53	39	26
Poland	34	-6	54	+5	85	24	51
Slovenia	58	-8	34	+7	43	36	49
Slovakia	42	-8	50	+8	75	20	46
average	36	-6	53	+6	75	24	48

Source: EOS Gallup Europe, September 2005.

views on the likely effect of the euro on prices and attitudes towards the single currency. While the correlations between expectations of price abuse during the changeover and attitudes towards euro adoption are relatively high (-0.65 for those for the single currency and 0.68 for those against), they are dwarfed by the link between the overall impact of the euro on prices and the desirability of euro adoption. The correlation between the percentage in each country which is happy about the introduction of the single currency and the percentage which believes the euro will contribute to price stability is 0.89 and the inverse correlation between those unhappy about euro adoption and those who believe the euro will be a force for stable prices is -0.95 .

Padfield and Verdun note that policy-makers in the Czech Republic and Hungary do not feel 'that public opinion had a direct impact on the time-frame and method of euro adoption' (Padfield and Verdun, 2005, p. 28). However, they do feel that 'the fiscal requirements for euro adoption would be complicated because of negative public opinion regarding cutbacks to social spending' (*ibid.*).

Consequently, one can posit a model in which expectations of price stability or inflation under the euro drive popular sentiment concerning the single currency, but that in itself is not what concerns policy-makers the most. In countries with significant fiscal problems, it is the expectation of resistance to structural reforms necessary to fulfil the Maastricht criteria that worries the elites (see below).

The ability to fulfil the Maastricht criteria

This section examines which of the Maastricht criteria has been a binding constraint for the economic policy of each country and how policy-makers have been dealing with these binding constraints and their influence on the expected entry date. There are five Maastricht criteria, concerning public debt and fiscal deficits, inflation and long-term interest rates as well as exchange-rate stability. We leave the criterion of exchange-rate stability for the next section. Here, we start with the criteria concerning debt and long-term interest rates, which do not pose a major problem, and then proceed to the two binding constraints – the inflation and fiscal deficit criteria. (The criteria are set out in two protocols to the Treaty establishing the European community: the Protocol on the convergence criteria referred to in Article 109j of the Treaty establishing the European Community and the Protocol on the excessive deficit procedure. They can be found *inter alia* on the ECB website.)

Article 2 of the Protocol on the convergence criteria states that to consider a member state in compliance with the deficit and debt criteria, it must be true that 'at the time of the examination the Member State is not subject of a Council decision under Article 104c(6) of this Treaty that an

Table 11.4 Government debt levels, eurozone and new member states (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Eurozone	74.3	73.6	72.2	69.6	69.3	68.1	69.3	69.8	70.8
Czech Republic	12.2	12.9	13.4	18.2	26.3	28.8	30.0	30.6	30.5
Estonia	6.4	5.6	6.0	4.7	4.7	5.5	6.0	5.4	4.8
Latvia	n.a.	9.8	12.6	12.9	15.0	13.5	14.4	14.6	11.9
Lithuania	15.2	16.5	23.0	23.8	22.9	22.3	21.2	19.5	18.7
Hungary	64.2	61.9	61.2	55.4	52.2	55.0	56.7	57.1	58.4
Poland	44.0	39.1	40.3	36.6	36.7	39.8	43.9	41.9	42.5
Slovenia	n.a.	23.6	24.9	27.4	28.4	29.7	29.1	29.5	29.1
Slovakia	28.6	28.6	43.8	49.9	49.2	43.3	42.7	41.6	34.5

Source: Eurostat.

excessive deficit exists'. 'Excessive deficit' has two components – public debt and fiscal deficits. The debt criterion focuses on whether the ratio of government debt to gross domestic product exceeds a reference value of 60 per cent.

It is clear from Table 11.4 that the debt criterion is not a binding constraint on eurozone entry in the new member states with the possible exception of Hungary. The three Baltic states have had low and stable debt levels. The Czech Republic and Slovakia experienced rapid increases in their debt/GDP ratios in the late 1990s and early 2000s, but these changes generally reflected the conversion of implicit transitional liabilities into explicit ones rather than a real increase in government liabilities. Since then, they have kept their debt on sustainable trajectories. Poland and Slovenia managed to stabilise their debt at medium levels between 30 per cent and 45 per cent of GDP.

Only in Hungary was the Maastricht ceiling of debt at 60 per cent of GDP exceeded (in the mid-1990s), due to the high level of debt inherited from the Communist period (Orban and Szapary, 2004). The subsequent fiscal restraint and significant privatisation revenues drove the debt down (*ibid.*), but the absence of either has pushed it up again since 2002. The real problem of Hungary, however, is an irresponsible fiscal policy which, via high fiscal deficits and interest rates, also pushes up debt. A return to a sustainable and credible fiscal policy path would also mean a solution to this problem; so in this sense, the debt criterion is not really the binding constraint for Hungary either.

The criterion on the convergence of interest rates means, according to Article 4 of the protocol on the convergence criteria, that

a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the

Figure 11.1 Long-term bond yields in the eurozone and new member states, 2001–05 (%)

Source: Eurostat.

three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long term government bonds or comparable securities.

Long-term interest rates (see Figure 11.1) have converged to the eurozone level from highly variable initial levels, with the exception of Hungary and Poland. This convergence reflected in part a decrease in inflation and inflation expectations in some countries, but also the credibility of their expected eurozone entry with financial markets. The two countries where the rates have not converged with the eurozone are the ones where there is either no date set for entry into the eurozone (Poland), or the date set is not credible (Hungary) and for which markets expect the latest entry out of all the new member states in the sample.

After dealing with the debt and interest-rate criteria, let us proceed to inflation. The protocol on the convergence criteria stipulates in Article 1 that a member state fulfils the price-convergence criterion, if it

Figure 11.2 Inflation in the eurozone and new member states, 2004–05 (%)

Source: Eurostat.

has a price performance that is sustainable and has an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability.

Figure 11.2 shows the convergence of headline inflation towards the required level in most of the new member states during 2004 and 2005. Despite this, the Maastricht criterion concerning inflation has been the key binding constraint. The fact that the reference value is set at a rather low level, given an inevitable dispersal of inflation rates, makes achievement of this criterion something of a roulette. If one takes into account the fact that supply-driven prices, such as oil and food, have a greater impact on overall inflation in the less developed economies of new member states, the roulette does not provide very good odds.

This is particularly so given the fact that the three reference countries on which it is based do not have to be, and indeed quite often tend not to be, members of the eurozone. Indeed, during 2004 and 2005, five out of the ten states that served as reference countries at some point during the two years were not members of the eurozone. Therefore, it is not surprising that during 2004 and 2005 the eurozone as a whole was very close to the maximum reference values and even exceeded it once.

On the positive side, the inability to achieve the required inflation in a given year has no permanent consequences; it only requires one to play

again the following year. Therefore, countries with particularly negative external shocks to prices can wait for a year and then qualify. However, countries with rigid nominal exchange rates might experience repeated problems in qualifying because of the interaction of their exchange rate regime with rapid real exchange rate appreciation and one-time inflationary shocks.

Real exchange rates have been appreciating strongly in all the eight countries since the beginning of the transition process. The trend has been particularly strong for the Baltic countries, which opted for a highly undervalued currency following their independence from the Soviet Union and then saw appreciations of their equilibrium real exchange rates of nearly 300 per cent during the 1992–98 period according to some estimates (De Broek and Slok, 2001). However, even in the Central European group, trend appreciation has been demonstrated for the 1993–2001 period though the trend has been extremely uneven (Beblavý, 2006). The appreciation has generally continued in the more recent period in the run-up to EU membership and since then.

The appreciation is usually attributed to what Halpern and Wyplosz call 'rapid gains in efficiency once markets drive prices and allocation of resources' (Halpern and Wyplosz, 1997, p. 458). These include:

- the 'investment demand channel' where 'rising productivity in any sector raises the equilibrium capital stock in the economy and thus raises investment demand which in turn increases prices' (Fischer, 2002, p. 27);
- a 'brand improvement' effect with increases in international prices of domestically produced tradables due to the gradual establishment of reputation and penetration of western markets and capital accumulation in the tradables sector (Lipschitz and McDonald, 1990); and
- the Balassa–Samuelson (B–S) effect, present in fast-growing countries, which increases the equilibrium real foreign exchange rate due to differing productivity growth in the traded and the non-traded sector (Balassa, 1964).

While there is a general consensus that, for the eight acceding countries, there has been an appreciation of the equilibrium exchange rate (Egert *et al.*, 2002), relating the actual real exchange-rate appreciation convincingly to the theories presented above has been quite difficult (Mihaljek, 2002). At the same time, it is not accidental that the two countries with the largest problems with the inflation criterion (Estonia and Latvia) combine very high levels of growth in production and productivity with currency boards. If high growth pushes the real exchange rate upwards, the currency board regime transforms this appreciation into higher inflation. In other words, while the Czech Republic, Poland and Slovakia have been able to use

nominal appreciation to manage the impact of real exchange rate appreciation on inflation, this route is closed to countries with currency boards.

At the same time, there is nothing inevitable about higher inflation for Estonia and Latvia. Not only did they have lower inflation at times of equally strong growth performance in the past, but neighbouring Lithuania with an equally impressive growth performance and a similar though not identical fixed exchange rate has had a much lower inflation rate. However, it is likely that this policy mix makes it difficult to react decisively to additional inflationary impulses, such as those caused by world energy prices or other supply-side shocks.

In other words, fixed nominal exchange rates make it more difficult to achieve the Maastricht inflation criterion under conditions of rapid productivity growth and inflationary shocks.

The fourth criterion explored in this section is the fiscal deficit. It focuses on whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value of 3 per cent.

Table 11.5 provides a recent history of fiscal deficits in the eurozone and new member states. When one examines this table, it becomes clear that fiscal deficits are the norm rather than the exception in all the new member states other than Estonia. At the same time, Latvia and Lithuania had significant fiscal deficits only in the aftermath of the Russian crisis of 1998 and have since brought them down significantly. Slovenia has also been successful in sustained deficit reduction. However, it is also clear that fiscal indiscipline is the binding constraint in terms of the Maastricht criteria for the Central European four (the Czech Republic, Hungary, Poland and Slovakia) and that the deficit is of a structural nature (Dabrowski, 2005, p. 42).

Several questions then emerge: Why is this so? What can one expect in the future? In trying to explain the reasons why it is so difficult to contain

Table 11.5 Fiscal deficits in the eurozone and new member states (% of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Eurozone	-2.6	-2.2	-1.3	0.2	-1.9	-2.5	-3.0	-2.8	-2.4
Czech Republic	-2.5	-4.2	-3.4	-3.7	-5.9	-6.8	-6.6	-2.9	-2.6
Estonia	1.9	-0.3	-3.7	-0.6	0.3	1.0	2.4	1.5	1.6
Latvia	n.a.	-0.6	-4.9	-2.8	-2.1	-2.3	-1.2	-0.9	0.2
Lithuania	-1.1	-3.0	-5.6	-2.5	-2.0	-1.4	-1.2	-1.5	-0.5
Hungary	-6.8	-8.0	-5.6	-3.0	-3.5	-8.4	-6.4	-5.4	-6.1
Poland	-4.0	-2.1	-1.4	-0.7	-3.7	-3.2	-4.7	-3.9	-2.5
Slovenia	n.a.	-2.2	-2.1	-3.5	-3.9	-2.7	-2.9	-2.3	-1.8
Slovakia	-5.5	-4.7	-6.4	-12.3	-6.6	-7.7	-3.7	-3.0	-2.9

Source: Eurostat.

the fiscal deficit in the Central European four compared to their peers, it quickly becomes clear that the obvious explanations do not fit.

First of all, it is difficult to explain the issue in terms of their limited ability to raise revenue. Hungary, the Czech Republic and Poland have a revenue/GDP ratio that is close to the eurozone average and higher than for any of the Baltic countries (Table 11.6). Given their status, globally, of high middle-income countries, the revenue is certainly at the high end of the spectrum. In the Czech and Hungarian cases, it is also not declining, but stable or mildly rising. In the Polish case, there was a significant drop during the economic slowdown of 2000–01, but from a high level.

The deficit is also clearly not of a cyclical nature as all the countries, with the possible exception of Poland, have witnessed strong growth close to or even above their potential for several years.

It is the expenditure side of fiscal policy that is much more useful in explaining the persistent deficit issue. Hungary has an expenditure/GDP

Table 11.6 The revenue/GDP ratio in the eurozone and the new member states (%)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Eurozone	46.6	46.2	46.8	46.3	45.6	45.2	45.2	44.9	45.3
Slovenia	n.a.	n.a.	n.a.	44.3	44.7	45.4	45.2	45.3	44.9
Hungary	n.a.	n.a.	44.4	44.3	44.7	43.7	43.4	44.1	44.3
Czech Republic	40.0	38.8	39.2	38.5	39.1	40.4	41.1	41.7	40.8
Poland	41.7	40.0	40.8	39.6	40.0	41.0	39.9	38.6	40.5
Estonia	40.9	39.1	39.1	37.9	37.4	37.8	39.1	37.9	38.5
Latvia	38.3	40.6	37.0	34.7	33.7	33.4	33.5	34.9	37.7
Slovakia	58.8	57.1	49.8	47.6	37.2	36.1	36.0	36.7	34.9
Lithuania	39.6	37.4	37.5	35.8	33.1	32.9	31.9	31.9	34.2

Source: Eurostat.

Table 11.7 The expenditure/GDP ratio, eurozone and new member states (%)

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Hungary	n.a.	n.a.	49.9	47.4	48.2	52.0	49.8	49.5	50.4
Eurozone	49.2	48.4	48.0	46.2	47.4	47.8	48.3	47.7	47.7
Slovenia	n.a.	n.a.	n.a.	48.1	49.0	48.0	48.1	47.6	46.7
Czech Republic	42.4	43.8	42.9	42.1	45.0	47.3	47.7	44.6	43.4
Poland	46.4	44.3	42.7	41.0	43.7	44.2	44.6	42.5	43.0
Slovakia	65.0	60.8	56.9	59.9	43.8	43.8	39.8	39.8	37.9
Latvia	36.8	41.3	42.4	37.5	35.8	35.6	34.6	35.9	37.5
Estonia	39.2	39.5	42.8	38.3	37.1	36.8	36.7	36.4	36.9
Lithuania	50.9	40.4	40.3	39.3	35.1	34.3	33.2	33.4	34.7

Source: Eurostat.

ratio of 50 per cent, above the eurozone average (Table 11.7). Poland and the Czech Republic have ratios hovering around 45 per cent. This is still ten percentage points above the average for the Baltic countries (35.1 per cent in 2004). As Von Hagen (2004) notes, the Central European governments appear comparatively oversized for their *per capita* income levels even if their openness is taken into account.

At the same time, it is worth noting that Slovenia and the Czech Republic have high employment rates of 64–65 per cent of the 15–64 population, higher than the employment rate in the eurozone (Table 11.8). The Baltic states have employment rates that are lower, but between 61 and 63 per cent are close to the eurozone level. Slovakia, Hungary and Poland have witnessed significantly worse performance, below 60 per cent.

In other words, the Baltic states have implemented a model of limited but fiscally prudent government. Hungary, the Czech Republic and Poland have implemented a model of a post-communist welfare state, but without the fiscal ability or political will to fully fund it. Slovenia and Slovakia are outliers. Slovenia has managed to implement a fiscally prudent post-communist welfare state due largely to its ability to retain high employment and consequently a large fiscal base, while Slovakia has tried to shift between the groups – from Central Europe to the Baltics.

In terms of future expectations, Slovakia seems on track to consolidate its public finances at a much lower level of redistribution, while the Czech Republic and Poland have recently been able to squeeze their deficits below 3 per cent on the back of strong cyclical performances. Hungary, with its low employment rate, mediocre GDP growth and structural fiscal problems, seems unlikely to be able to fulfil the deficit criterion on a sustainable basis without major structural reforms. Consequently, the ambitions of the Czech Republic, Hungary and Poland to emulate Slovenia might require

Table 11.8 Employment rate, 15–64 age group, in the eurozone and new member states (%)

	1998	1999	2000	2001	2002	2003	2004
Slovenia	62.9	62.2	62.8	63.8	63.4	62.6	65.3
Czech Republic	67.3	65.6	65.0	65.0	65.4	64.7	64.2
Eurozone	59.3	60.6	61.7	62.2	62.4	62.6	63.0
Estonia	64.6	61.5	60.4	61.0	62.0	62.9	63.0
Latvia	59.9	58.8	57.5	58.6	60.4	61.8	62.3
Lithuania	62.3	61.7	59.1	57.5	59.9	61.1	61.2
Slovakia	60.6	58.1	56.8	56.8	56.8	57.7	57.0
Hungary	53.7	55.6	56.3	56.2	56.2	57.0	56.8
Poland	59.0	57.6	55.0	53.4	51.5	51.2	51.7

Source: Eurostat.

more or less structural reform, but there is no indication as yet of any ambition to change the fiscal paradigm.

ERM II entry and exchange-rate management

So far, we have ignored the last Maastricht criterion of exchange-rate stability. Article 3 of the Protocol on the convergence criteria states the following:

The criterion on participation in the exchange rate mechanism of the European Monetary System...shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.

Within ERM II, a currency of the participating member state has a fixed central parity with the euro. There is a fluctuation band of 15 per cent around the parity and both the member state and the ECB are, in principle, committed to unlimited interventions to preserve the parity. However, this is not an ironclad commitment as the ECB does not have to intervene if such a step would threaten price stability (Folsz, 2003, p. 5), a provision used by the Bundesbank when it refused to rescue the British pound in 1992.

The new member states tend to see participation in ERM II either as an irrelevance (those with currency boards or soft pegs) or as a potentially dangerous inconsistency in their monetary policy framework (all others). Backé *et al.* (2005, p. 6) provide a succinct summary of their attitudes:

Most acceding countries regard ERM II as an institutional requirement for the adoption of the euro that cannot be avoided, but whose appropriateness as an exchange rate policy framework is questionable. Overall, they perceive ERM II as a 'waiting room' that offers at best little value-added and may even entail certain risks.

It is not surprising that those countries that have had a difficult (Poland) or disastrous (the Czech Republic, Slovakia) experience with soft pegs are wary of another commitment, especially since it may easily clash with their price stability objective and/or the Maastricht inflation criterion. According to Folsz, there is indeed 'a risk that in practice the new exchange rate system might work as a unilateral fixed exchange rate mechanism, and, as such, it might leave the member states' currencies highly vulnerable to speculative

attacks' (Folsz, 2003, p. 11). For Estonia, Latvia and Lithuania, with currency boards or long-standing narrow pegs, it is an irrelevance because the ECB and the old member states have agreed to accept their exchange rate regimes as compatible with ERM II so, for them, entry presents no actual change.

On the other hand, the view from Frankfurt is quite different, at least in principle. According to Issing (2005), the two-year participation in ERM II is not so much a dangerous or an irrelevant waiting room, but a necessary testing room, designed to check the actual ability of new member states to participate in the eurozone through the ability to maintain an unchanged central parity for two years. The ECB as a whole sees participation in ERM II as useful in terms of ensuring fiscal discipline, enhancing exchange rate credibility as well as adjustability and providing multilateral support for the exchange rate regime (ECB, 2003).

However, in real life even the ECB urges caution in joining ERM II: 'It is important to undertake major necessary policy adjustments – for example with regards to price liberalisation and fiscal policy – in the pre-ERM II phase' (Issing, 2005, p. 4). Therefore, there is very little pressure on new member states to join ERM II more than two and a half years before their expected date for the switch to the single currency. (Two and a half years is necessary because the decision on whether a country will join the single currency needs to be made at least six months prior to entry for a variety of technical reasons.) Estonia, Lithuania and Slovenia joined ERM II in June 2004 with the objective of adopting the euro on 1 January 2007. Latvia followed them in May 2005 and its expected euro date is 1 January 2008. Only Slovakia, with the euro target date of 1 January 2009, moved sooner than necessary in November 2005.

Consequently, the view of ERM II as a largely redundant but inevitable waiting room has prevailed in practical policy-making.

Conclusion

We have reviewed some issues related to eurozone entry of the eight new EU member states from Central and Eastern Europe. They have all pledged themselves to adopt the single currency and join the eurozone as soon as they are ready and to work steadily towards this objective. The front-runners are expected to join on 1 January 2007, while the rest of the group is spread out well into the next decade.

The chapter has examined which of the Maastricht criteria has been a binding constraint for the economic policy of each country and how policy-makers have been dealing with these binding constraints and their influence on the expected entry date. While the debt or interest rate criteria have not generally been a major problem and the exchange rate stability criterion is treated as an afterthought, the fiscal deficit and inflation criteria have been the real challenges.

The inflation criterion continues to present an unpredictable challenge to all who hope to join the eurozone simply because it is low given the recent high variability of inflation. It has become a roulette in which both supply-driven prices (such as energy prices) and the moving target of the average inflation in the three countries with the lowest inflation in the EU can be more influential in whether countries hit the target in a given year than the actual conduct of monetary or fiscal policy. Ironically, high growth coupled with a truly stable currency can also become a winner's curse, as appreciation in the real exchange rate punishes what is usually regarded as a winning combination. This is the case in Estonia and Latvia.

The fiscal deficit criterion provides a benchmark that has been achieved by some (Baltic states, Slovenia), but is proving nearly impossible to surmount for others (Central Europe). The differences are not due to asynchronous business cycles, but are based on widely differing expenditure ambitions and abilities to finance them. Slovenia has managed to implement a fiscally prudent post-communist welfare system. The Baltic states have implemented a model of government with limited redistributive ambition, but with a very developed sense of fiscal responsibility. The Central Europeans have attempted to emulate a fully fledged welfare state, but do not seem to have the fiscal ability or political will to fully fund it. However, this group is breaking up, with Slovakia heading towards the Baltic model, while the other three attempt to emulate Slovenia.

The exchange-rate stability criterion calls for member states to complete at least two years in ERM II without parity devaluation. The policy-makers in the new member states see the exchange-rate mechanism as an inevitable but either irrelevant or potentially dangerous precondition for the eurozone entry. As a consequence, the timing of ERM II entry has been decided as an afterthought to the overall euro adoption strategy, with the intention of spending the least time necessary in it. So far, only Slovakia has committed itself to participating in ERM II sooner than absolutely necessary, but only for six months longer.

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